University of Alberta

TAFTA - a proposal for a Transatlantic Free Trade Area

by

Joerg Bierbass

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Abstract

The idea of a Transatlantic Free Trade Area (TAFTA) reflects the willingness of the European Union (EU) and the North-American Free Trade Area (NAFTA) for further trade liberalization. The Transatlantic Free Trade Area promises some advantages for both parties, but it also includes significant risks. The main problem of a free trade area between these two important trading blocs is that it weakens the multilateral approach of trade liberalization. Yet, the Transatlantic partners do not have to resign the potential gains from the liberalization by TAFTA, if they are willing to share these gains with other countries. Both the EU and NAFTA should force transferring the agreements of the Uruguay-Round and liberalize the sectors that are not at all or not sufficiently covered by the World Trade Organization (WTO).

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TAFTA - a proposal for a Transatlantic Free Trade Area

1. Introduction

The suggestion of a Transatlantic Free Trade Area between the countries of the European Union (EU) and the North American Free Trade Area (NAFTA) has been brought to discussion by influential European and American politicians. A free trade area is regarded from both sides mainly as a shift in motivation for a reinforcement of bilateral political cooperation after the end of the cold war. In Europe, there is fear of a re-orientation of North America towards the Pacific causing isolation; on the other hand, from an American perspective, Europeans are tending to shift towards Eastern Europe and the results of the currency union are uncertain (Piazolo 1996, p. 103).

At the same time, with the Asia-Pacific Economic Cooperation (APEC) occurs another suggestion for regional integration between big trading nations. The declared aim of APEC is the creation of a free trade agreement that covers the whole Pacific area until the year 2010 for industrialized countries of the region - including the United States, Canada and Japan - and until the year 2020 for other nations.

Both approaches of regional integration with the United States and Canada as participants as well as the consolidation and the extension of the European integration run parallel to the planned realization of the results of the Uruguay-Round. This parallelism raises questions regarding the effects of

a Transatlantic Free Trade Area: Is TAFTA a threat for the multilateral approach of the World Trade Organization (WTO) or does it open a new way for free world trade that cannot be reached by the WTO? May TAFTA be able to accelerate multinational liberalization? If a cost-benefit-analysis concludes that TAFTA is not the "king's way" for liberalization, could the existing willingness for liberalization be integrated in a multilateral approach and, thus, be enforced?

This thesis analyzes the reasons for and against a Transatlantic Free Trade Area, considers alternatives and closes with a recommendation for a multilateral approach towards a liberalization between NAFTA and the EU.

The subject of this investigation is to identify the possibilities and boundaries of such a free trade area which is based on international work sharing and the general principles of the WTO: multilaterality and non-discrimination.

The course of this analysis is as following: The second chapter investigates ways regional liberalization supports or counteracts the aims of the WTO and describes recent experiences with European and American trade policy. The third chapter derives concrete conditions for successful negotiations. Finally, conclusions of the analysis are briefly summarized in chapter four.

2. Trade liberalization

2.1 Theory of free trade

Few concepts relating to economic policy are based on such solid theoretical and empirical foundations as that of free trade: Free trade raises the wealth of all trading nations because there is more space for specialization, it leads to greater efficiency of factor allocation and it postpones barriers of growth. Free trade is not a zero-sum game where some countries win an equal value that others lose. In an open economy like Germany, industry benefits considerably when trade barriers are opened (Sachverstaendigenrat 1994, p. 231).

New export markets enable companies to grow. Higher volume of output leads to lower unit costs which improves the competitiveness in pricing. Open borders allow companies to obtain favourable preliminary and intermediate products and to participate in worldwide technological progress. Furthermore, each nation benefits from reactions in other nations: Trade improves the standard of living abroad, too. As foreign markets grow, the demand for products from abroad increases. World trade is certainly not a one-way street. Industry sectors that compete with imports have to adapt to greater competition. The necessary search for better products and improved production methods is often seen as difficult. Yet, if this step has been made, products will be more competitive on domestic and foreign markets.

The possibilities to adapt are not the same in all sectors. It is useful to distinguish intra-industrial trade from inter-industrial trade. The former is typical for trade between industrialized countries - e.g. EU, United States and Canada. These countries possess similar labor and capital and use similar production technologies; homogenous goods are traded. Trade takes place because of different consumer preferences. Increased import pressure can be compensated by higher exports. Assuming, a European industry sector is afraid that it will be pushed back if the trade barriers against the United States are demolished. What will happen? Engineers in these respective companies have to rationalize their production process. Purchasing officers must look for new markets. Sales representatives have to market the products more efficiently. Marketing managers must track down new customer needs and develop new ideas for products. All managers have to support this process (Freytag/Zimmermann 1996, p. 4). In summary, competition will uncover weakness and force remedies. If this adaptation can be done, competitiveness on domestic and foreign markets will be strengthened and companies will be faced with new opportunities for export.

Inter-industrial trade, on the other hand, is typical between industrialized and developing countries that have different resources. The advantages of industrialized countries include capital-intensive production processes and a highly-skilled, trained and qualified labor force. Developing countries use simple production methods with less qualified labor. After TAFTA is established with Mexico, sectors in Europe that currently compete with imports from Mexico will face strong pressure for adaptation. Neither more capital-intensive production nor an attempt to decrease wages - hardly possible in central Europe - will be able to compensate in the long run for the

fundamental Mexican cost advantage. These sectors will lose income and employees will have to move to other expanding sectors.

Often labor is not willing to adapt to structural economic changes and calls on the government to protect the domestic sector against foreign competition. The argument is strong in a moral sense - for example, defense against ecological or social dumping (construction industry in Germany) or the supply from single (German) sectors is threatened (coal mining, agriculture). On the contrary, companies in specific future oriented industries will be supported (space science, micro technology). The consequences of these arguments are the same: Jobs are kept temporarily that under free competition will face a pressure to adapt, the costs of which are carried by the majority of unprotected companies. This is often not recognized since it is difficult to relate these costs to the economic cause: protectionism. To better understand the effects of protectionism the folowing – theoretical – issues have to be considered (Freytag/Zimmermann 1996, p. 5 f.):

- German or European protection of specific sectors results in retaliatory acts of those countries that are excluded from the respective market. Those countries seal their markets off to European exports. Regularly, this process affects competitive domestic companies.

- Export subsidies as in agriculture or micro technology have to be financed. They increase taxes or national debt and thus raise interest rates. This increases capital costs for companies; necessary investments do not take place thus endangering future competitiveness.

- Trade barriers cause upward pressure on prices of preliminary products for processing industries. Prices of final products fall behind in their competitiveness.

- Protected domestic producers of preliminary and intermediate products may miss connection to international improvements in technology. International competition does not force these companies that hide behind "protection walls" to follow new trends and inventions. The processing industries that order relatively underdeveloped products from protected industries lose their competitiveness, too. If, for example, the European production of semiconductors is subsidized, this may become a burden for the European automobile industry, mechanical engineering, etc., where semiconductors are used.

- There is a demand for foreign currency in order to pay for imports. If the German import demand for foreign products decreases because of protectionism, the demand for foreign exchange will decrease. This causes a revaluation of the German Mark which reduces imports and counteracts the original intent. On the other hand, German exports become more expensive - again, as a burden for more competitive industries. Import protectionism results - ceteris paribus - in a higher external value of the German Mark than free trade does.

- Protected industries are able to pay higher wages than unprotected industries under free trade. Unprotected industries will be forced to offer higher wages too, if they want to avoid the fact that employees leave for protected, higher paying companies. There is a similar result for capital

and preliminary products: funding costs and prices for preliminary products increase in unprotected firms since the scope for protected companies has become broader.

- Domestic demand will decrease because of higher taxes for domestic taxpayers and higher prices for consumers.

- Finally, economic growth slows down because unavoidable structural changes are left undone or are postponed. In the long run, the protected sectors have to shrink operations, dismiss employees and close plants. In Germany, the history of agriculture, hard coal mining, the iron and steal industry, dockyards, and the textile and clothing industry illustrates this in a more or less dramatic way.

2.2 Regional vs. multilateral trade agreements

Free trade may be utopia; an approximation has best been reached in the past with multilateral trading rules. The fact that national trade ministers tend to protect specific domestic sectors is a burden to their foreign competitors - and other domestic companies. That is nearly the same in all countries. But if there is protection everywhere, possible trading profits cannot be realized. This problem can be solved by accepting effective rules. This is the central task of multilateral trading rules, including GATT (General Agreement on Tariffs and Trade) and, since January 1995, the WTO that includes GATT 1994. These rules are designed to protect domestic and

foreign companies against the arbitrary political intervention of governments that generally hurt unprotected companies (Siebert 1995, p. 5). More concretely, these rules offer preservation for both domestic and foreign companies against protectionism by the other side. International legal protection for companies increases so that there is a more reliable basis for long-term projects. International trade law fulfills the same function as domestic private law - even if it is more difficult to assert. Despite all of its inadequacies - the basic rationale of international trading rules is not questioned even by critics - GATT has been able to prevent a welfare-decreasing competition in protectionism.

A basic rule of GATT and WTO is the principle of non-discrimination that is expressed in the MFN (most-favoured-nation) clause (Art. I GATT). Every facilitation of commerce for one trading partner has to be granted immediately and unconditionally to each WTO member country. Thus, a selective trade policy that favours some countries and discriminates against others is excluded and tensions between countries that are rooted in different treatment are reduced. Under this principle, liberalization can be enforced and negotiation costs can be decreased because there is no necessity to bargain with every contract partner on a bilateral basis (Hauser/Schanz 1995, p. 14). Many tariffs have been reduced in this way during the last few decades.

Regional integration like TAFTA stands for a break with this principle. Selected trade partners agree to mutual preferential terms and third parties are excluded. Subject to certain conditions, free trade areas and customs unions are covered by GATT (Art. XXIV GATT). The stabilizing effect of WTO depends on respecting the rules. Thus, it is in the interest of an industry that these regulations to guard against protectionism are not watered down.

A superficial view might suggest that regionally restricted trade liberalization is better than none. But a more accurate analysis shows that connections are more complicated. Generally, two effects have to be differentiated: trade creation and trade diversion. Trade creation occurs when the production of goods or services in a country that is a member of a free trade area is replaced by less expensive imports of another member after the tariff barriers have been abolished. Trade diversion, on the other hand, occurs when a member country replaces the imports from a third country - that has been a cheaper source for supply before the free trade area was founded - by tariff-free imports from a member even though its production costs are higher than in the third country. From an economic perspective, the former effect has to be assessed as positive, the latter as negative. Taking a view from the perspective of a domestic industry sector, this judgment is reversed. This might be illustrated by applying the theory of customs unions (Siebert 1982, p. 666):

A customs union is an alliance of two or more independent countries to one common customs area. It is characterized by two criteria: common external commercial policy and abolition of internal tariffs. Tariff zones and national boundaries are not the same.

There are some differences between a customs union and a free trade area such as TAFTA: Internal tariffs are abolished but there is no agreement on common external tariffs. Every country still sets its tariffs for third countries autonomously. Since there are no common external tariffs, but rather a free exchange of products inside the free trade area, there might be price differences for products and inputs from different countries of origin in the short run. In order to exclude arbitrage, which dodges the trade agreement,

rules of origin become important.

Using the theory of customs unions, the question whether the aim of improving welfare among the members can be reached is analyzed.

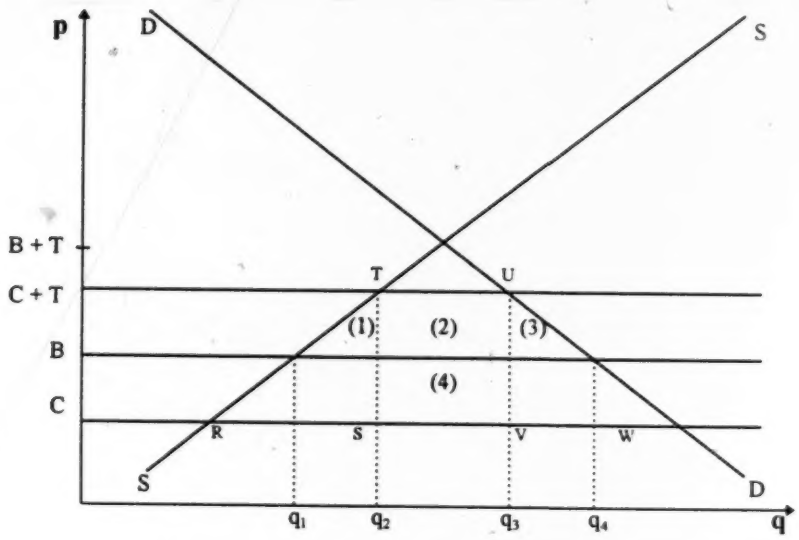

Figure 1: Comparative-static partial analysis of a customs union (Siebert 1982, p. 668).

Graph SS shows the supply curve and DD the demand curve of country A that forms a customs union with B. CC characterizes the completely elastic supply curve of the third country C (assumption of a small country). Before the customs union is established, country A commits customs clearance with tariff T so that the supply curve of the third country C is given by C + T . Country B is not competitive when there is customs clearance

(B + T). Country A produces the quantity q_2, the demand is q_3 and it imports $q_3 - q_2$. The revenues received by tariffs result from the areas (2) and (4). Country B is not competitive in this situation. Country A suffers a welfare loss that amounts to the triangles RTS plus UVW.

If the countries A and B found a customs union, country B will become competitive since the supply curve BB (without tariffs) lies below the supply curve of country C (with tariffs). Country A reduces its production from q_2 to q_1, increases its demand from q_3 to q_4 and imports the larger quantity $q_4 - q_1$. The additional trade between A and B (additional imports by country A) is connected with the break down in trade between country A and the third country C. The additional trade results partly from trade diversion. Country A receives a gross welfare gain that amounts to the areas (1), (2) and (3) (consumers' rent) and it loses the revenues from tariffs (2) and (4), so that net welfare changes by (1) + (3) - (4). To simplify this analysis it is necessary to assume that revenues from tariffs have been transferred to households without administrative costs.

The effects on welfare will be larger

1 the higher the tariffs have been before the customs union is formed because the higher protection has been and the greater is the effect of trade creation;

2 the lower the common external tariffs of the customs union are because the effect of trade diversion is lower;

3 and the larger the customs union is because the earlier prevails the effect of trade creation.

From a world economic perspective the assessment is clear: trade creation results in a more efficient allocation of resources and gains in welfare while trade diversion leads to losses in welfare. Worldwide liberalization of trade means that the most efficient supplier receives a respective contract. In this way, scarce resources maximize the resulting earnings for everybody's wealth. An economically useful regional liberalization can just mean that inefficient production is replaced by a more efficient one - as in the case of trade creation. This includes the possibility that there are less expensive suppliers in other countries that do not participate in the free trade area. However, they did not receive contracts even before the regional liberalization was started. From an economic perspective, it will not be useful if liberalization leads to the situation that more efficient companies are replaced by less efficient ones - like in the case of trade diversion. Affected industry sectors take a reverse perspective: The domestic industries of countries A and C have produced (more) products before the free trade area was founded and will probably dislike the trade agreement. The incentives of the respective industries for creating TAFTA would include: First, trade creation has to be prevented if their own products are relatively expensive and has to be supported if their own products are more competitive. Second, trade diversion can be tolerated if there is no domestic production or even has to be supported if trade will be directed towards the domestic production.

But this would be a rather short-sighted strategy. It has to be analyzed which position trade creation and diversion take regarding protection. As it was mentioned before, protection that supports less competitive domestic companies inevitably endangers the competitiveness of unprotected domestic

industries. Trade creation means that old protecting walls are demolished without building new ones. Costs that result from protection will decrease for domestic industries. In the case of trade diversion it is different; bilateral reduction of protection results in new barriers against efficient suppliers from third countries. The costs of protectionism for unprotected domestic industries still exist. Furthermore, if efficient suppliers of third countries are excluded, these countries will start retaliatory actions (Piazolo 1996, p. 113 f.).

There are some more crucial points regarding a policy that avoids trade creation to protect import substituting industries. As mentioned before, in the case of intra-industrial trade there is the possibility of using the export "valve" after a successful adaptation. Taking this view, it depends on the management of the respective companies to retain in the market. New inter-industrial trade will force a structural change and dynamic sectors will profit most. To reject this change that is caused by trade creation means to misunderstand the lessons of two centuries of economic history. Specifically, protection against foreign competition cannot stop necessary structural change but only postpone it - and the costs for late adaptation will be higher. Besides, trade creation enlarges the markets and, as a result, dynamic gains from higher volume of output and resulting lower costs per unit have to be considered.

In summary, there cannot be a difference between interests of the whole economy and single sectors; every industry has to strive for trade creation without trade diversion.

During the last decades trade barriers like tariffs have been reduced, but simultaneously non-tariff barriers like quantitative import quotas, voluntary export restraints, etc. have been introduced. Here, the economic

assessment of trade creation and trade diversion is different from traditional judgment. Trade diversion is not always negative (Wonnacott/Lutz 1989, p. 64). Such selective instruments for protection do not ensure - in contradiction to homogeneous, non-discriminating tariffs - that the most efficient suppliers fulfill the orders if the external trade barriers are low - or not, if the barriers are high.

A simple example will illustrate this special feature. Production costs for checkered vests may be 30 marks in Mexico, 40 marks in Japan and 50 marks in Europe. Mexican and Japanese exports to Europe are restricted to 10,000 and 20,000 vests each year. Before the foundation of TAFTA, these quantities may be exported to Europe where production plants are less efficient. Within the scope of the negotiations for TAFTA the quotas for Mexico are dropped for vests. As a result, trade between Europe and Mexico will be generated because the expensive European production will be replaced. Moreover, trade will be directed from Japanese to Mexican suppliers. This is positive too, because less efficient producers are replaced by more efficient ones. The discriminating abolishment of non-tariff trade barriers may cause disagreement in third countries that do not profit and may result in retaliatory actions. This assessment does not change if it is assumed that Japan is the cheapest supplier. TAFTA will result in trade creation between Mexico and Europe but not in trade diversion from Japan to Mexico if the Japanese import quotas are not lowered.

To summarize this chapter, trade generally has to be liberalized on a multilateral level. If trade is liberalized on a regional level the basic rules of the multilateral trade agreements have to be considered. Since 1992, the world's regional trade arrangements have nearly doubled to over 100. Whether any regional agreement will ultimately contribute to or abstain from free trade depends on how its size and composition affect the welfare and competitiveness of its member countries. Empirical studies, accounting for the costs and benefits of regional trade preference, have suffered from substantial difficulties in isolating indicators and interpreting the politically contentious results. However, recent theories of international competition conclude that government involvement in global oligopolies may pay off, provided that it effectively blocks foreign entry into home or third markets (Boscheck 1997, p. 10). This position looks at trade as head-on competition to enter new markets or upgrade otherwise non-competitive industries. Here, trade is at best a zero-sum if not a negative-sum game; competitiveness centers on the ability to shift adjustment costs. Regional trade preferences have become popular devices for managing trade and adjustment. By combining elements of free trade, protectionism, and sectoral targeting, these arrangements can provide the means for restructuring global production in line with free trade.

Regarding the reduction of tariffs, the assessment of TAFTA depends on the relative weights of the expected effects of trade creation and trade diversion. Negotiations have to focus on a high level of trade creation - at which third countries will participate because of dynamic effects - and a low level of trade diversion that hurts third countries and may cause retaliatory actions (Trebilcock/Howse 1995, p. 427f.). Thus, negotiations on TAFTA should decrease high tariffs to generate trade. The reduction of low tariffs

should be accompanied by a parallel reduction of external trade barriers to avoid trade diversion. The ratio of trade creation and trade diversion depends on negotiations and is higher (Wonnacott/Lutz 1989, p. 68):

1 the higher the degree of liberalization because the larger is the competitive pressure against protected industries by more efficient suppliers from other member countries (more trade creation, dynamic gains);
2 the smaller the cost disadvantage of the most efficient suppliers from member countries is in relation to the most efficient suppliers from third countries (less trade diversion);
3 the smaller the external trade barriers against third countries (less trade diversion);
4 the larger the free trade area since more countries gain from trade liberalization (higher possibility of trade creation and less possibility of trade diversion).

The reduction of non-tariff trade barriers is less crucial since trade diversion leads to improvements in efficiency. It is necessary that protection towards third countries is not increased but rather decreased. Although non-tariff trade barriers have become more important, most agreements just focus on the reduction of tariffs (Siebert 1994, p. 184).

2.3 Chances and risks of TAFTA: cooperation vs. confrontation

International trade policy has become more complex over the last few years. On the one hand, GATT-negotiations, especially the Uruguay-Round, have led to considerable reduction of trade barriers. Tariffs have been decreased, escalations have been gradually overcome and - especially in agriculture - many non-tariff trade barriers have been changed to equivalent tariffs. There have been even some negotiations on a multinational level about sectors such as textile and clothing, although with mixed results. The United States as well as the EU have been active players in this process. On the other hand, trade politicians have often established new instruments of protection. Not just because of this, the chances and risks of TAFTA have to be further investigated to find institutional rules that help both sides without hurting third nations or endangering the multilateral system.

Lingering disagreements over trade issues have thus developed into visible differences on important matters. In the United States, since the late 1980s, increasing frustration in bilateral economic relations with a number of Asian countries, together with a persistent aggregate external deficit, has fueled a drift toward bilateralism, often assisted by threats of direct sanctions. Europe, on the other hand, has found itself more and more involved in negotiations to open up its markets to third countries, often for political rather than economic reasons. Almost without knowing it, Europe has become and has been perceived as an advocate of liberalization and multilateral rules in world-wide trade.

In 1994, bilateral trade flows in goods and services between the European Union and the United States amounted to approximately US$ 230 billion, around 20 % of both sides' total trade. Over and above the volume of bilateral trade is the extensive network of direct investment that links companies in both markets. Taken together, two-way EU-US direct investment was about US$ 476 billion in 1993. Almost 42 % of total US foreign direct investment is in the EU, while 56 % of total European foreign investment is in the United States. More important, European subsidiaries of US firms account for about 30 % of total EU shipments to the United States. Similarly, US subsidiaries of EU parents account for about 37 % of US imports from the European Union and 12 % of total US exports to the European Union (Micossi 1997, p. 62). As a comparison, Japanese investment in the United States amounts to about 23 % of the total, and only 10 % of US investment abroad goes to Japan. Cross-border investment between the European Union and the United States also far outpaced that between the US and other APEC countries (US$ 329 billion). As a combined bloc, North America and Western Europe would be a leviathan accounting for roughly 65 % of world trade.

In the following section, there is a description of the instruments that are used today by the US and the EU to protect important sectors in order to show the current situation and development.

As previously mentioned, the significance of tariffs continually decreased on both sides of the Atlantic ocean. The average tariff in the EU against third countries decreased from 8.8 % in 1970 to 6.3 % in 1993. Similarly, the average tariff in the US has been dropped from more than 10 %

in 1967 to less than 5 % in 1991 (Meier 1995). But that does not mean that protection is not a problem anymore. Instead of tariffs, there are different forms of non-tariff trade barriers that normally cause even more rejections. The development of instruments that are used by the US and the EU is very similar. In both regions, there is an increase in the use of import quotas as well as anti-dumping and countervailing duties. But there are some differences, too. The US tend to negotiate bilaterally on volume of trade while this happens less often in Europe. On the other hand, the EU tends to subsidize some sectors excessively and several regulations still protect the service sector against competition. In the following paragraphs, there is a deeper analysis of these instruments.

Import quotas especially restrain trade in the textiles and clothing industry. However, the US as well as the EU just use this instrument against developing nations (e.g. Mexico) and Japan as the only industrialized country. Generally, Japan is the aim of most agreements regarding quantitative restraints (including voluntary export restraints).

For example, the EU negotiated in 1991 a voluntary export restraint agreement on cars with Japan. This contract limits the Japanese direct exports to the EU from January 1993 until the end of 1999 to 1.23 million units each year. This number is equivalent to the import volume in 1990. A special problem are the so-called "transplants", those cars that are produced by Japanese plants in a country of the EU, e.g. Great Britain. These units do not belong to the quota but their number is critically observed - especially by France (Siebert 1994, p. 179). The EU expects to effectively protect the European producers so that they are able to adapt to structural changes that

increase productivity. Yet, it has to be questioned if this aim is reached without the pressure of international competition. When the contract expires in 1999 the automobile producers may be less competitive since they expect the government to renew the agreement. From an economic perspective, the voluntary restraint is an export cartel and the rents that are paid by European consumers are extracted in Japan. Moreover, there is the problem of "upgrading": Japanese companies tend to export cars of a high quality because of the quantitative restraints and, thus, European producers of high quality cars face more intense competition than other car producers.

The US protect their automobile industry, too, as well as imports of semiconductors from Japan (Tyson 1992). Besides, the American administration more and more tends to decide one-sided retaliatory actions based on its trade legislation against countries that incur its displeasure. A current example is the Helms-Burton law, enacted in March 1996, that allows US companies to sue foreign companies operating on their properties confiscated by the Cuban government during the 1959 revolution.

From this development it is possible to derive two main conclusions for TAFTA. First, the US appear increasingly aggressive against trade partners. They will only agree to contracts with the EU if the American exporters - especially American farmers, banks, and telecommunication companies - get a recognizable possibility to enter the European markets. Second, every attempt by the US government to negotiate market outcomes have to be negated. Agreements that obligate the EU to voluntary import increases or fixed market shares for American companies contradict the basic rationality of trade liberalization. Competition is an open process and the abolishment of trade barriers offers the same chances for all trading firms.

Who wins or loses has to depend on the ability of the respective company and not on the will of trade diplomats.

From an economic perspective, dumping is just a problem when specific conditions apply. These prerequisites can be clearly defined: The sale of a product on a foreign market is done beneath the "normal price" at the home market in order to drive out competitors and gain long-term monopoly rents (predatory dumping). In this situation, anti-dumping actions are justified in an economic sense. Yet, it is difficult to determine the right costs.

With increasing liberalization, it becomes more unlikely that an aggressive supplier can receive monopoly rents after eliminating its competitors. New suppliers will enter the market because they are attracted by high rents and less barriers of entry. In practice, predatory dumping is irrelevant (Hauser/Schanz 1995, p. 84).

The five-step anti-dumping procedure of the EU opens a lot of scope for the European commission to decide whether an anti-dumping tariff might be set in force. Often, it is not necessary to act because the excused foreign company voluntarily agrees to increase the price of the respective product. As in the EU, anti-dumping duties in the US are selective and somehow mysterious. Moreover, in the US "anti-dumping action is applied with particular zeal" (Raworth 1991, p. 116). With completion of the Uruguay-Round and the newly formulated anti-dumping codex, the rules in the US and in the EU became fairly similar (Hauser/Schanz 1995, p. 82).

The number of imposed anti-dumping duties is staggering over recent years. But this does not say much about the detrimental effects of protection since accused exporters often commit to raise prices before a due process of the law is started.

In the European Union many branches of industries are subsidized. Next to agriculture and some national exceptions as coal in Germany and steel in France and Italy, the European air and space industry also receives public support.

A very interesting example to analyze further is German hard coal. The world market price "free Bremen" in 1993 was about 80 marks per (metric) ton. The production costs in a German mine are about 290 marks per ton. A substantial part of the cost difference is financed by public subsidies. Every job in the mining industry is subsidized by 75,000 marks per year. But, next to subsidies, import permits for just about 10 million tons are issued and, thus, play an important rule in protecting the domestic market, too. Finally, there are several more measures taken. The so-called "century contract" (Jahrhundertvertrag) obliges German electric power generating companies to use domestic coal. The quantity of coal that has to be bought every year amounts to 40 million tons. Besides, German electric power suppliers have to pay an earmarked compensating rate of about five pennies per kilowatt hour - the so-called "coal penny" (Kohlepfennig) - that is regularly forwarded to consumers. And a special contract (Huettenvertrag) binds the German steel industry to purchase coke coal until the year 2000 whereas the difference to the world market price is refunded.

Since European subsidies directly cause pressure against the US competitors, there occurs an obvious conflict potential. Besides, there are several regulations in Europe - especially in the telecommunication sector - that interfere with the trade in services of third countries like the United States. Instruments such as subsidies and regulations are used less in North America than in the EU.

Problems during negotiations on TAFTA will especially occur in sectors that are currently protected most. These are agriculture, the air and space industry and the service sector.

Although the problem has been a little alleviated recently, nowhere else are economic undesirable developments as serious and opposition against changes as large as in European agriculture. This is detrimental to consumers and especially to other sectors. Countries such as the US are not willing to approach European export interests in other sectors if the EU does not open the market for agriculture. Thus, a sector that contributes less than 2 % to the German GDP endangers increases in employment somewhere else - saying nothing about the high costs for protection and environmental pollution because of intensive use of fertilizers. TAFTA offers the possibility for a coalition between policy and industry associations to enlarge the pressure for reforms so that agriculture can be liberalized and potentials for sustained growth are enhanced.

There will be similar problems regarding the support for the air and space industry in Europe. As an example, Airbus Industries is still considerably subsidized by the European commission and national governments. This support is often justified using the argument of strategic trade policy (Siebert 1994, p. 111). Applying the Brander-Spencer-model as the basic model for dyopol theory, it is possible - under special assumptions for the market entry of newcomers - to divert gains from abroad to the domestic market. But, in practice, there has not been much success yet. Instead, this project has caused huge economic costs and ongoing conflicts with the United States. On the other hand, the American support for producers of large airplanes, including Boeing and McDonnell Douglas, must also be

investigated. There has been a recent shift from direct support by the military budget to support by American technology policy.

The third sector that will probably cause serious problems if there are negotiations on TAFTA is, as mentioned before, the service sector. As the German demand for services from banks, insurance companies, telecommunication companies, etc. is important, the German industry will be interested in the best possible supply - in Germany as well as in other export markets. The opening of service markets increases the variety of supply and increasing competition reduces prices and results in better service. The telecommunication market offers unused possibilities, correspondingly, restraints against a complete opening of the market are strong. During the last few years, several steps have been taken to liberalize markets, but there are still markets in the US and Europe that are not completely open for foreign competition. Market entry for domestic countries will be facilitated in the EU until 1998 and there are similar plans in the US. Foreign companies are often still limited to entering minority interests in domestic firms. This has resulted in some joint ventures with American and European stockholdings. Yet, in February 1997, after three years of negotiations, a WTO conference on telecommunications in Geneva reached agreement to open the markets of member countries. Thus, China and Russia are excluded; both still have to become WTO members. In the short term, the principal beneficiaries of the agreement will be the bigger companies with a well developed international presence. Almost 70 countries representing about 90 % of the world's telecommunications revenue signed this contract. This can be interpreted as an indication that there do not have to be companies that lose in this growing market, apart from firms in those countries which believe they can continue to make profits protected by trade barriers.

It has been shown that protectionism in Europe and North America has impeded world trade. Many actions are not directed against the Atlantic partner but against Japanese or other East-Asian companies. There are still several protective barriers that will be abandoned in case of a Transatlantic integration. This will have positive economic effects, if trade creation exceeds possible trade diversion. After all, there will be consequences for sectors that are opened; former protected sectors will face stronger import competition and competitive companies get new opportunities.

In summary, regional trade liberalization, like TAFTA, can be very supportive for the German economy - especially if dynamic gains from economies of scale and a more intensive search for new products and production methods are considered. But TAFTA also includes significant risks. First, trade diversion because of a bilateral reduction of tariffs is equivalent with protection of those domestic companies that receive this trade. Costs are carried by other, non-protected domestic firms. Second, and this is the central danger of TAFTA, bilateral agreements may burden those countries that do not participate in negotiations (Trebilcock/Howse 1995, p. 427 f.).

There are several possible causes (Zimmermann/Freytag 1996, p. 23):

- If barriers between North America and the EU are demolished trade can be diverted from efficient suppliers of third countries to less efficient suppliers inside TAFTA.

- Restrictive rules of origin have a protective effect. They divert trade from efficient suppliers of preliminary products of third countries to less efficient companies of TAFTA countries.

- The reduction of internal borders intensifies competition inside TAFTA. This may increase the tendency to compensating higher external protection.

- If two major trading blocs join forces, there will be a critical concentration of trading power. The US and the EU may be tempted to reach advantages by using aggressive trade policy against third countries that carry the costs.

Even if countries are excluded from negotiations there will be a serious potential for distrust and annoyance. All this may lead to retaliatory actions by third countries such as the South and East-Asian nations. If the US and the EU sign bilateral contracts, Japan may coordinate the interests of the left out nations. A trade conflict between different blocs may endanger the multilateral approach of trade liberalization whose previous achievements have been very helpful for many economies.

It will just be a short-term perspective to gain advantages by burden third nations. A long-term perspective has to include resulting retaliatory actions by other nations that have a negative impact on domestic welfare. As a result, every nation lacks welfare. Thus, it is in the interest of every country to decrease negative impacts on third nations.

In view of the dominating position of the US and the EU for the continuing improvement of multilateral trade liberalization, Europeans and

Americans have to be aware of the signal effect of TAFTA. A Transatlantic agreement must not endanger this system but has to strengthen it. The dictates of the moment are to multilateralize a possible free trade area.

If the economic Transatlantic agenda is focused on providing effective market access for a broad range of products and thus contributing to reducing systemic friction and economic insecurity, then not only will the relationship between the European Union and the United States have been fundamentally strengthened, but substantial economic gains will also have been made. Moreover, this approach offers an opportunity to experiment with new solutions to problems that have, traditionally, not been part of trade negotiations, thus indicating the paths that can later be followed in a broader multilateral forum such as the WTO.

3. An agenda for TAFTA

3.1 A regulatory framework for the integrating world economy

The world economy is characterized by increasing globalization and a more intensive interdependence of economic decisions. Transaction costs become less relevant and new technologies have supported a fragmentation of production. While the mechanism for allocation, the world market, becomes more global, economic decisions are still made on a decentralized level.

An international framework - a regulatory framework - is necessary so that allocation processes are not disturbed and transactions are less uncertain. The basic idea for such a world trade system has to be that international work sharing takes advantage of the potential gains in welfare between countries that have different resources and preferences resulting in net gains for all participating economies.

As a central element of this regulatory framework, nations have to submit to basic rules that help to avoid strategic actions of single countries which may lead to wins from international trade for only a few nations, as well as an increase in welfare that in total is smaller. Such rules have to prevent the non-cooperative behavior of countries without excluding competition among nations.

The content of this regulatory framework depends on the kind of interdependence between countries. Traditionally, trade political rules aim at

facilitating trade in goods. Nowadays, issues like social standards as well as rules for services and competition are discussed, too. Besides, norms focusing on the mobility of factors of production as capital, labor and technology attract attention in discussions about economic policy.

GATT, the basic regulatory framework for international trade that aims at impeding the strategic behavior of single countries and enforcing cooperative behavior, has to be further developed and consolidated. There have been some positive tendencies in the world economic system. During eight periodic multilateral trade negotiating "Rounds", focusing on tariff reduction and, later, on non-tariff barriers to trade and new trade-related aspects, trade has been thoroughly liberalized. The most-favoured-nation principle multilaterizes the reduction of trade barriers.

On the other hand, there are several reasons why a free market-entry could not yet be implemented in this framework:

- Countries have dodged tariff liberalizations by other regulations as, for example, voluntary export restraints and technical restrictions, whereas the international trade system was not able to include those instruments in its institutional regulatory framework.

- Safeguard measures in cases of large increases in imported goods or actions against export subsidies are permissible, even on a selective basis, against single suppliers.

- Anti-dumping procedures have a protective character and limit competition because they introduce uncertainty and because the threat can lead to "voluntary" export restraints.

- Sectoral exceptions from the principles of non-discrimination and most-favoured-nation in the areas of agriculture as well as textiles and clothing represent a violation of the basic concept of international work sharing.

- Finally, the WTO has a relatively weak mechanism for sanctions if single countries depart from rules. Even after the Uruguay-Round, retaliatory measures that are authorized by the WTO may still be ineffective against large trading nations. Besides, the WTO still cannot institute proceedings against nations on its own.

The multilateral trade system is characterized by a certain helplessness against bilateral trade policy. It is important to set limits to this bilateralism. Aggressive trade policy of major trading nations and regions in the world endanger the multilateral system. The EU and the US built up an arsenal of trade political instruments that can be used as retaliatory measures or to open markets without paying attention to the mechanisms of the international trade system. That way, the US can react with their instrument, "Section 301", in a short period of time to trade political actions of other countries and introduce trade restricting measures against single countries on their own. Trade privileges can be canceled, import restriction imposed and bilateral agreements on export restrictions implemented. The EU has introduced a similar new trade political instrument. With these instruments, two trading

blocs position themselves as result-orientated, bilateral systems outside the adjusted, multilateral international trade system (Siebert 1995, p. 7 f.). Such a situation has to be prevented.

The spatial exception from the principle of most-favoured-nation that applies to regional integration generally threatens the multilateral system and may cause it to fall apart into regional blocs. However, in respect to previous experiences, regional integration has not led to considerable segmentation. Regional efforts for integration in Latin America have been weak and the new regional integration in Eastern Asia (APEC) focuses on market integration rather than on sealing off markets. The European integration still attracts other nations and its growth - with reservation - has overcompensated trade-diverting effects to the debit of third nations. The free trade area in North America does not have a similar internal coherency as does the European Union. But the danger that regional blocs may fall into an escalating trade war cannot be entirely dismissed. For example, NAFTA may have an intensifying effect on a possible aggressive trade policy of the US in case of an argument between blocs. As a result, it is important to identify mechanisms to multilaterize regional integration. For instance, regional trading areas have to be accessible for new members and participating countries may commit themselves to realize the results of the Uruguay-Round faster, liberalize more and make less use of exceptions. This may result in improvements for the integrating world economy. Furthermore, this also accounts for plans to interlock different regional blocs by founding a free trade area such as TAFTA. One way this may be accomplished would be to have members of regional trade areas grant concessions, that are given to participating nations,

to third countries too, in the sense of a conditional most-favoured-nation principle.

3.2 Main ideas of the WTO

From an economic perspective, TAFTA is only justified if it does not contradict to multinational trade rules. By definition, free trade areas stand for a break with the fundamental principle of GATT which has been adopted by the WTO: non-discrimination (Art. I GATT). Specific countries grant preferential terms that are refused to third countries and, thus, discriminate.

Since GATT negotiators knew about the possible positive effects of regional agreements on trade liberalization, they included regulations in the agreement that allow regional integration under specific, though not precisely formulated, conditions. Free trade areas and customs unions will be legitimated by GATT, if

- tariffs and other regulations of commerce "on the whole" are not "higher or more restrictive than the general incidence of the duties and regulations applicable ... prior to the formation of such union" (Art. XXIV: 5(a) GATT);

- participating countries agree on reduction of trade barriers that includes "substantially all the trade between the constituent territories" (Art. XXIV: 8 GATT); and

- the integration is realized in between a "reasonable length of time" (Art. XXIV: 5(c) GATT).

Thus, the aim of regional integration is to improve trade inside this area without discriminating the trade of third countries with partner countries of the regional agreement. In other words, as much trade creation as possible and as little trade diversion as possible. If trade barriers against third countries are increased, more trade will be diverted. There will be similar results if the agreement only includes specific sectors. The analysis in the last chapter has shown that negotiations always bear the danger that they follow protective interests of particular sectors. As a result, sectors where trade is created to the debit of domestic import competition are excluded and, vice versa, sectors are liberalized if participating countries can mutually divert trade to the burden of third countries. In order to avoid this situation, countries are obliged to liberalize as many sectors as possible so that trade will be created even if this results in difficult adaptations by domestic industries. Regardless of this discernible guideline, there are many details that include considerable vagueness and a scope for interpretation. Therefore, Art. XXIV has often been criticized and improvements have been urged (Voigt 1992, Senti 1994):

- Which method forms the basis for determining tariffs and trade rules in their "general incidence"? Are they weighted or not? Are goods included that are not subject to tariffs? How are tariff equivalents for non-tariff trade barriers chosen?

- What does "substantially all the trade" mean? How is it measured and what are the threshold values? Does agriculture as well as the textile and clothing industry belong to it?

- When is the length of time "reasonable"?

- What will be the possible sanctions if a free trade area obviously is not in conformance with the conditions of Art. XXIV?

Some of this criticism has been taken up by the Uruguay-Round and specified in the section on "Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994":

- It is recognized that the contribution to the expansion of world trade is increased if the liberalization between participating countries "extends to all trade, and diminished if any major sector of trade is excluded". Yet these findings do not provide precise conditions to prove if a perspective free trade area is in conformity with the WTO. At the same time, it is expressed that regional agreements on integration will comply with the basic ideas of the WTO if trade barriers of all sectors are decreased. As a result, negotiations on TAFTA also have to deal with the agricultural policy of the EU. A bilateral opening of the European market of agriculture will only cause few trade diversions since just a small quantity of agricultural products are imported from third countries. It will lead to more trade creation because the European production is replaced by less expensive imports from North America.

- The evaluation of trade barriers applicable before and after the formation of a customs union is based on an overall assessment of weighted average tariff rates, while the determination of the incidence of other regulations of commerce can require further examination.

- The "reasonable length of time" is not more than 10 years. Exceptional cases have to be explained to the Council for Trade in Goods.

- Up to now, so-called working parties have regularly investigated if regional agreements on integration have been in conformance with GATT. But no agreement has yet been declared as not conforming with GATT, even when it has been controversial because consensus has been necessary (Jackson 1993, p. 127). The different interests of participating countries and third countries in these working parties have mutually blocked unanimous decisions (Voigt 1992, p. 165). In the meantime, the WTO has strengthened the dispute settlement procedure, that - in contrast to the old procedure - includes disputes between countries of a free trade area and third countries. Besides, decisions made by the multinational Dispute Settlement Body cannot - again as opposed to the old procedure - be blocked by single nations. If a country does not follow a particular instruction, the other country will be allowed to demand compensation or to introduce retaliatory actions.

The most important task for the multinational system of world trade with regard to areas of regional integration is to minimize distorting trade

effects and to multilaterally settle conflicts between integrating blocs. Sectoral trade barriers against third countries must not be increased, but - if possible - be diminished. Furthermore, negotiations on TAFTA must include sensible sectors such as agriculture.

3.3 Aspects of the Uruguay-Round

The concern that TAFTA undermines the WTO can be lessened when North America and the EU commit themselves to reduce the deficiencies of former multilateral negotiations. Thus, these countries may realize the results of GATT-Rounds faster than originally planned, liberalize more sectors than agreed upon before and make less use of exceptions. This does not include all tariffs and technical regulations since trade diversion may occur.

The results of the Uruguay-Round can be classified in three areas: older controversial issues, previously excluded sectors and recent controversial issues. In the following analysis, results of the Uruguay-Round are briefly summarized and criticized. Furthermore, some recommendations for negotiations on TAFTA are given.

3.3.1 Older controversial issues

3.3.1.1 Rules of origin

Rules of origin are national laws or ordinances that determine the country in which goods are held to originate. Generally, they become relevant if countries depart from the most favoured nation clause so that imported goods are discriminated depending on their country of origin. Preferential rules of origin that are applicable to preferential trade agreements, such as NAFTA or the EU, can diminish possible trade creation and divert trade to the debit of third countries. Thus, this problem is analyzed in detail in the following section. As a first step, the basic rationality of rules of origin is investigated.

In both a customs union and a free trade area, trade barriers between countries are reduced. Yet, there are differences regarding the external protection against third countries. While countries in a customs union agree to a common external commercial policy, member nations of a free trade area keep their own policy towards third countries. As a result, countries of a free trade area have different levels of trade barriers towards third countries that may cause trade diversion.

As an example, the European tariff on Japanese machines is 10 %, while the American tariff is 20 %. After the foundation of TAFTA, a Japanese producer will probably not export directly to the US because of the higher tariff. Instead, they will export their machines to Europe in order to transport them further to the US without paying tariffs - provided that the costs for transportation increase less than the savings on tariffs. Thus, taking advantage

of different trade barriers results in inefficient transport distances and undermines national trade policy towards third countries. To avoid this situation, either the EU and NAFTA have to decide to found a customs union where no trade diversion occurs, or they have to determine rules of origin preventing products manufactured outside TAFTA from being exempted from tariffs.

Goods that are wholly produced in one country are held to originate in that country. When goods are produced in two or more countries, it is often more difficult to determine the country of origin.

As an example for the latter, in a three-stage production process exploitation of coal takes place in Australia while steel production and, finally, the manufacture of automobiles happens in the EU and the US. Tariffs on Australian coal are 35 % in Europe and 10 % in the US. After the foundation of TAFTA, steel and automobiles are mutually traded without being liable to duty, while national tariffs towards Australia remain the same. European producers of automobiles may not buy their steel in Europe anymore, but rather from the US, since American steel producers obtain Australian coal for a lower price than their European competitors. As a result, in accordance with rules of origin it has to be determined whether imports are entitled to preferential treatment or whether, on the contrary, they are subject to tariffs. Generally, the country of origin is the one where the last "substantial transformation" took place (Raworth 1995, p. 77). Thus, if the processing of Australian coal to American steel is "substantial", this steel can be delivered to Europe without paying duties. On the other hand, if this is not the case, this steel is still an Australian product and has to be declared when exported to Europe.

Basically, there are three procedures in which the criterion of substantial transformation can be determined:

1. a given percentage of local added value or content,
2. particular manufacturing or processing operations, or
3. a change in tariff classification.

Yet, the practical organization of these rules of origin can cause several costs that have to be avoided:

- The local content rule seems to be unequivocal. A product is considered to originate in the free trade area if the added value in this region reflects a minimum share of the overall value of this good. But there are no common rules to determine this share as a certain percentage. Thus, any minimum content is arbitrary. For example, if the content is relatively high, automobile factories may decline to buy inputs from manufacturers of third countries even if they are cheaper. Alternatively, they may switch to suppliers inside the free trade area in order to fulfill the necessary percentage of domestic content. The higher the percentage of minimum content, the more trade from efficient suppliers of inputs from third countries is diverted to less efficient producers of the free trade area. Manufacturers of inputs are protected in detriment of producers of final products. As an alternative, those producers can renounce the preferential treatment and order inputs from less expensive suppliers outside TAFTA. This possibility becomes even more attractive as the costs for certificates of origin increase. Moreover, the net domestic production share depends partly on variables that cannot be influenced by respective companies, e.g.

fluctuations of exchange rates or changing costs for inputs. A study on effects of rules of origin of free trade agreements between the EU and single countries of EFTA (European Free Trade Area) showed that costs for certificates of origin for exporting companies amounted to between 3 and 5 % of the export value, so that in about 25 % of all exports from EFTA to the EU, companies renounced possible preferential treatments and paid duties (cited in Palmeter 1993, p. 53 f.).

- Rules of origin that require particular manufacturing or processing operations are susceptible to misuse, as NAFTA illustrates. There, certain production processes are prescribed for the textile and clothing industry favouring capital-intensive processes in the US and discriminating against labor-intensive manufacturing in Mexico (Hufbauer/Schott 1993, S. 44). Mexican producers of this sector are in fact excluded from NAFTA. Besides, those rules of origin have to be continuously monitored and revised because of technical developments.

- Substantial processing normally entails a change in the tariff classification of imported materials that have been processed. Here, products are classified in different numbered product groups where the numbers regularly consist of 4 up to 8 digits. Yet, it has to be decided at which level a change in tariff classification takes place. The higher the level of aggregation the more restrictive are the rules of origin. Besides, as NAFTA has illustrated, there is the danger that many different product specific rules of origin are created (Palmeter 1993, p. 51). Finally, the classification system has to be constantly updated.

All three procedures to evaluate the criterion of substantial transformation have major disadvantages. But, the method based on tariff classification seems to cause less costs for companies and customs authorities. If negotiators on TAFTA decide on one homogeneous level for all products that is as disaggregated as possible, there will be less danger of trade diversion.

In practice, agreements on free trade areas often combine all three methods. For example, the free trade agreement between Canada and the US includes about 1,500 relevant regulations on specific products (Krueger 1995, p. 74). This complexity is increased by different free trade areas with different rules of origin, and further regulations for import quotas and anti-dumping procedures, resulting in substantial information costs for companies.

In summary, rules of origin are connected with varied costs. They increase the information and administrative costs of domestic and foreign companies that have to prove the origin of their products. This becomes more and more difficult because of the globalization of production processes. Accordingly, less trade is created since companies tend to renounce the use of preferential treatment. As a result, restrictive rules may be interpreted as protective misuse.

Domestic producers of inputs are protected from competition with suppliers of third countries to the detriment of non-protected domestic companies. This trade diversion can cause retaliatory actions by affected countries. The scrutiny of declared origin of products by domestic public authorities increases administrative costs. Finally, negotiations on rules of origin seem to be troublesome.

Considering all costs, the best economical solution is to found a free trade area without rules of origin. Thus, participating countries have to tolerate inefficient transport routes and renunciation of independent external trade policy (Lloyd 1993, p. 703). A high protection of single sectors will be undermined if another nation protects this sector less. From an economic perspective, comprehensive trade liberalization leads to higher trading profits and less resistance by third countries. Uneconomical transportation patterns have to be compared to varied costs of rules of origin. Besides, the transportation problem seems to be temporary because national trade barriers against third countries may adapt to diverted trade streams. Ineffective protection of single sectors may be corrected to the lower level of other nations of the free trade area. Most notably, the discriminated producers of final products will be urged to diminish trade barriers favouring producers of inputs.

On the other hand, it is restricted to increase the lower level of protection of another member country to the higher domestic level. Article XXIV of the GATT rules that tariffs and other regulations of commerce "on the whole" are not "higher or more restrictive than the general incidence of the duties and regulations applicable ... prior to the formation of such union" (Art. XXIV: 5(a) GATT). Accordingly, the external protection of TAFTA against third countries must not be increased.

As a result, market pressures seem to compel a European-North American customs union.

However, free trade areas have never renounced rules of origin. The second best solution are - in accordance with the former analysis - rules that are based on change in tariff classification. The "Agreement on Rules of Origin" of the WTO has established general principles for the implementation of national rules of origin for the first time. Besides, member countries agreed on the involvement of the WTO in a new harmonization program. A committee has to develop the use of change in tariff classification as a means of meeting the criterion of substantial transformation. A major principle for the harmonization program is that the same rules must apply to all rules of origin within the scope of the agreement.

Although, the agreement only applies to all non-preferential policy instruments, Annex II sets out similar general principles for preferential rules. But there are two major exceptions for preferential rules. First, it is not prohibited to discriminate against exporters of third countries and, second, these rules do not have to be harmonized (Hauser/Schanz 1995, p. 131).

The following issues may be considered during TAFTA-negotiations on rules of origin:

- According to the "Agreement on Rules of Origin" of the WTO, there should be just one standardized application for all products. Besides, exceptions should not be granted for specific goods. As a result, information and administrative costs for companies and public authorities are lowered and the demand for protection of specific products is halted.

- The change in tariff classification as a means of meeting the criterion of substantial transformation should take place at a fairly disaggregated level. Thus, it is more likely that a substantial transformation is made in Europe or North America and, therefore, the danger of undesirable trade diversion is reduced.

- Because of the dynamic development of products, harmonized rules of origin have to be continuously made topical. In order to reduce legal uncertainty, new and not yet included products should be qualified as having their origin inside TAFTA.

- Protection against third countries should be reduced.

3.3.1.2 Tariffs

The step-by-step liberalization of market entry by reducing tariffs is the classical domain of multilateral trade negotiations in the course of GATT. In the area of tariffs on industrial goods, GATT was quite successful. The average level of tariffs was decreased from 40 % when GATT was founded in 1947 to less than 5 % at the end of the Tokyo-Round. Despite these improvements, negotiators of the Uruguay-Round faced several challenges:

- peak tariffs in some industrial sectors, e.g. textiles and clothing;
- peak tariffs in developing countries.

Proceeding from a low average level of tariffs, according to the decisions of the Uruguay-Round, import duties of the US and the EU have to be mutually decreased by 50 % in five steps during four years. Yet, it is problematic that tariffs on imported inputs have been decreased at a higher rate than tariffs on imported products. Thus, the domestic net production is more protected (Sachverstaendigenrat 1994, p. 45 f.). Hence, it is necessary that especially high European tariffs, e.g. on textiles, clothing and fishing products, are diminished resulting in trade creation. If low tariffs in other sectors are bilaterally reduced there will be a danger of undesirable trade diversion. In order to avoid this situation, tariffs have to be reduced for third countries, too.

Taking sectoral negotiations on chemical products as an example, several countries, including the US and the EU, agreed to a harmonization of tariffs in a range between 5.5 and 6.5 %. Yet, there is a transition period of up to 15 years that can be visibly shortened (Hauser/Schanz 1995, p. 67).

3.3.1.3 Quantitative trade restrictions

The Uruguay-Round determined that quantitative import restrictions are still permitted. A country can apply such a safeguard measure if a product is imported in such increased quantities and under such conditions "as to cause or threaten to cause serious injury to the domestic industry" (Art. 2: 1 Agreement on Safeguards). The underlying reason for safeguard measures is to give a perspective country a "breathing space" to adjust its industry to the competitive environment (Raworth 1995, p. 98).

In principle, it has to be claimed that NAFTA and the EU agree to an unrestricted prohibition of safeguard measures. Quantitative trade restrictions cause larger damage than tariffs. After a period of time, tariff barriers can be overcome when technological development in foreign countries result in less expensive production. In regard to quotas that stipulate a maximum quantity for imports, this is not possible. Besides, a bilateral reduction is less problematic as in the case of tariffs. Possible trade diversion will not replace efficient producers of third countries if import quotas are not decreased. Thus, existing safeguard measures - especially those against Mexico - have to be transferred to equivalent tariffs and diminished in a second step. Furthermore, quotas against third countries must not be lessened but rather increased as far as possible.

3.3.1.4 Subsidies

Subsidies distort international trade to the debit of those domestic and foreign companies that are not supported by the government. In contrast to dumping, subsidies are based on restrictive government intervention in the price and market mechanism and not on strategies of private companies. The relevant regulations for subsidies (excluding agriculture) are:

- The "Subsidies Code" of the WTO categorizes subsidies with a "traffic light" approach. Following this visualization, subsidies can be prohibited ("red"), actionable ("yellow") or non-actionable ("green"). Subsidies that aim at directing domestic demand from imported to domestic goods are

prohibited. An actionable subsidy causes "adverse effects" on the interest of other countries. Such effects are presumed if the subsidization exceeds 5 % of the product value. Countries that are suspected of maintaining an actionable subsidy have to dispel the suspicion. Finally, non-actionable subsidies are exempt from any action under the WTO rules. Generally, these subsidies are not specific. On the other hand, they can be specific for research and development, regional development or new environmental requirements.

- Disputes about foreign subsidies can be settled in two different ways. First, governments can start an action under the WTO dispute settlement. Second, companies can bring a countervailing action against subsidized imports to their national court. Similar to anti-dumping procedures, there is a de minimis rule for starting an investigation; if the subsidy is less than 1 % of the product value, the case will have to be dismissed (Hauser/ Schanz 1995, p. 93 f.).

In comparison to the former practice, the regulations of the "Subsidies Code" are a visible progress. But, negotiators on TAFTA have to aim at further improving these rules because a stronger bilateral disciplination of the allocation of subsidies provides advantages not only for non-subsidized companies inside TAFTA, but also for firms in third countries.

Hence, the threshold of 5 % of the product value for presuming an "adverse effect" caused by a subsidy can be lowered. Besides, this rule could be effective for the aircraft industry, too. Research will not have to be subsidized if it immediately leads to marketable products. Financial support

by the government for development costs could be prohibited or made actionable and that for industrial research could be more restricted. Furthermore, subsidies for regional development could be limited for a specific period of time, e.g. provided for 5 years.

The multilateral WTO dispute settlement procedure has to be preferred. The possibility to unilaterally decide on countervailing duties can be improperly used for protectionism.

3.3.1.5 Anti-dumping procedures

Generally, anti-dumping and countervailing duties are imposed on underpriced or subsidized imported goods, respectively, in order to protect domestic companies against unfair competition. These duties are referred to as "contingent protection" measures that are, however, susceptible to abuse and can constitute a very effective form of protection.

Dumping is not prohibited by GATT, but it allows retaliatory actions under certain conditions. Available remedies are provisional measures, undertakings and definitive anti-dumping duties that can be imposed retroactively. The main WTO-rules ("Anti-Dumping Code") include:

- Retaliatory actions can be taken when the following conditions are cumulatively met. First, there has to be evidence for dumping: the export price must be lower than the "normal value" of the goods. Second, the dumped goods must cause or threaten material injury to domestic industry. Finally, there has to be a causal connection between dumping and injury.

- An anti-dumping investigation can only be initiated if the application is supported by domestic producers that represent at least 25 % of total production of the like product in the importing country. The case will have to be dismissed if the margin of dumping is less than 2 % of the export price or if the dumped imports from a particular country account for less than 3 % of all imports of the like product.

- Detailed rules of evidence support a fair and complete hearing . All interested parties are allowed to provide relevant information.

- Anti-dumping duties are not mandatory and must not exceed the margin of dumping.

- A "sunset clause" provides that a duty has to terminate after 5 years unless a review provides information that a prolongation is necessary.

During the 1980's, anti-dumping procedures became the most commonly used form of protectionism. Between 1979 and 1988, three out of four actions that restricted imports were anti-dumping duties, while the share of steps following safeguard measures (Art. XIX GATT) was just 0.5 % (Messerlin 1990, p. 110 f.). Besides, during this period 98.8 % of anti-dumping investigations were initiated in the US, Canada, the EU and Australia. Hence, both the EU and the US bear responsibility for improper use of anti-dumping procedures.

From a welfare economic perspective and by considering that predatory dumping is statistically irrelevant, anti-dumping duties have to be abolished. Regularly, less competitive domestic producers ask for anti-dumping measures. If this was stopped, more expensive domestic industries would have to face a stronger pressure for adaptations. Governments can implement tariffs in order to protect single industries.

The following guidelines for improving the anti-dumping procedure may be considered during negotiations:

- The margin of dumping should be defined as the difference between export price and costs of production (plus administrative, selling and general costs). As a result, companies can take advantage of different price elasticities of demand in different markets. These companies will no longer be forced to lower the price on the domestic market to avoid anti-dumping actions, if the price elasticity there is lower than on the world market. Besides, companies can follow a pricing strategy that makes it easier for them to enter a foreign market or to sell residual quantities of their products.

- The criteria for dismissing an anti-dumping case can be modified. The margin of dumping can be increased to 10 % of the export price and the crucial quantity of dumped imports from a particular country can be raised to 15 % of all imports of the like product.

- Evidence provided by domestic consumers and producers, who will have to pay higher prices for products and inputs if remedies are imposed, should be considered during investigations ("public interest"-clause). Besides, the final decision of the respective committee should be based on a cost-benefit-analysis for the total economy, including the costs of protectionism for non-protected domestic industries (Hauser/Schanz 1995, p. 82 f.).

- Anti-dumping duties should be lower than the margin of dumping ("lesser duty rule").

- Anti-dumping measures should terminate after a shorter period of time and, generally, prolongations should not be permitted. Respective industries have to be forced to actions for necessary adaptations.

- Anti-dumping procedures of TAFTA have to be applied to companies of other countries, too, because these actions may focus more and more on efficient suppliers of third countries in order to alleviate the increasing competitive pressure inside the free trade area. This may cause undesirable trade diversion.

3.3.1.6 Technical barriers to trade

Technical regulations on characteristics of products as well as national conformity assessment procedures increasingly obstruct international trade. Respective national regulations are often complex and confusing. Exporting companies have to obtain extensive information and, if necessary, adapt their products or production methods to foreign stipulations that can even discriminate between single exporting nations or against domestic firms. Smaller exporting companies suffer most often from these problems.

The most important regulations of the "Agreement on Technical Barriers to Trade" of the WTO are:

- Technical regulations as well as conformity assessment procedures must respect the principles of national treatment and most-favoured nation. Technical measures must not restrict international trade more than is necessary to fulfill a legitimate objective, such as national security, public health and safety, environmental protection and the interests of the consumer. These must all be based on international standards.

- Standards have to be based on international standards whenever appropriate and must not create unnecessary obstacles to international trade.

- Conformity assessment procedures that are carried out in a foreign country must be accepted whenever possible.

Negotiations on TAFTA should follow the so-called "Cassis-de-Dijon-principle" that is valid for trade between countries of the EU. If products are manufactured in accordance to national regulations, they will be able to circulate without restraints in other EU-countries as far as they do not endanger health, safety or consumer and environmental protection. Thus, the most appropriate regulations are determined by the market. Harmonization, as an alternative, has a major disadvantage. Trade politicians, engineers and bureaucrats are hardly able to determine which technical regulations and standards are better than others. In analogy to product markets, competition should be used to find optimal measures.

Further, a bilateral deregulation of technical barriers to trade inside TAFTA can be critical. If NAFTA and the EU agree to such rules but third countries do not, there will be the danger of trade diversion from efficient suppliers of countries outside TAFTA to less efficient ones inside the free trade area. As a result, bilateral agreements contradict the general principle of non-discrimination of the WTO. Thus, for negotiations on TAFTA the following has to be considered:

- In contrast to the more or less non-committal WTO-rules, TAFTA should adapt to the "Cassis-de-Dijon-principle" that is used by the EU. Only in "sensible" areas as e.g. health care should exceptions be allowed so that exporters have to keep to respective national regulations. Besides, disputes should be settled on a multilateral level.

- Agreements on technical barriers to trade have to be multilateralized in order to avoid trade diversion. All interested third countries should participate in these negotiations if they agree to the basic principles. Thus, mistrust of those countries will be reduced and desirable competition of regulations will be improved on a broader scale.

3.3.1.7 Government procurement

Government procurement includes purchases of goods by governments on a central, regional and local level as well as by companies that are owned by the government for their own use, respectively. The agreement on government procurement does not directly belong to the other agreements of the Uruguay-Round. Thus, if a country joins the WTO, it will not automatically participate in the agreement on government procurement. Partaking countries are mainly industrialized countries such as the EU, the US, Canada and Japan. The most important regulations are (Hauser/Schanz 1995, p. 167 f.):

- Government procurement of goods and services as well as construction projects that exceed certain defined threshold prices have to consider the general principles of multilaterality and non-discrimination.

- Those companies that have submitted the cheapest offer or that best meet specific criteria of an evaluation receive a respective contract as a bidder (except if this contradicts "public interest").

- Every bidding company must have the possibility to start a judicial evaluation of the awarding process in order to claim compensation for a possible damage.

The bilateral opening of the government procurement sector is less problematic, since governments regularly favour domestic companies. Here, trade cannot be diverted. Governments should face a stronger pressure to justify themselves, if they do not choose the cheapest bidder. Besides, "public interest" should be defined more precisely.

3.3.2 Previously excluded sectors

3.3.2.1 Agriculture

Liberalization of world trade in agricultural products represented the largest hurdle that had to be taken by the Uruguay-Round. The establishment of a regulatory framework for the agricultural market and improvements in terms of market access as well as domestic and export subsidies are the important results and, thus, a cornerstone for negotiations on world trade.

The agribusiness is very regulated in many countries because of political and social reasons:

- Interest groups in agriculture are often well organized and, thus, able to assert their interests towards political decision-makers.

- Non-economical motivations for supporting domestic agriculture (e.g. securing a minimum national level of independence in agricultural products; contribution of farmers to conservation) can be easily mediated towards the public.

- The far-reaching absence of negotiations on agriculture in GATT has caused an unprecedented extent of protectionism and intentions for reduction naturally meet with stiff opposition.

Most notably, the EU disagreed with the more "radical" solutions that were suggested by the US and other agricultural produce exporting countries (Rayner et al. 1993, p. 1517). After difficult negotiations, a compromise has been reached that mainly follows the interests of the EU and reduces the pressure for adaptations faced by European farmers providing transitional periods and safeguards:

- Non-tariff measures have to be replaced with equivalent tariffs and, in some instances, with tariff quotas that assure a lower tariff up to a certain level of imports. Within the scope of this tariffication, tariffs have to be diminished step-by-step. The reduction amounts to an average of 36 %

over 6 years, starting in 1995. Any specific tariff is to be reduced by at least 15 %.

- Temporary surcharges on the importation of certain products can be levied if the volume of imports exceeds 5 to 25 % (depending on the respective product) or if the import price falls below the average level of the period between 1986 and 1988.

- Domestic product-specific subsidies are to be reduced by 20 % over 6 years where the governmental support amounts to at least 5 % of the production value of the respective agricultural product. Generally excepted from reductions are regional and environmental actions as well as non-product-specific support (Hauser/Schanz 1995, p. 182).

- Export subsidies have to be diminished by 36 % and subsidized quantities are to be reduced by 21 % over 6 years.

The bilateral opening of the agricultural market seems to be less problematic. There will be little trade diversion since trade with third countries is very limited. However, trade creation is an important issue in such instances where expensive European products face stronger competition and may be replaced by less expensive American agricultural produce. Besides, Article XXIV of GATT dictates that agriculture has to be included in negotiations on free trade areas. The decisions of the Uruguay-Round have to be judged as just a first step. Further steps have to follow. Alternatives are to liberalize more in a shorter period of time or to agree on further actions

starting in 2001, the end of the transitional period. In order to provide the agribusiness with more security for planning the difficult process of adaptation, the latter alternative seems to be more pragmatic:

- Tariffs as well as domestic and export subsidies have to be decreased further. After the year 2000, protecting measures may be linearly diminished by a certain percentage, e.g. by an annual rate of 5 %.

- Levying surcharges on the importation of certain products should be prohibited.

- Domestic subsidies may be reduced independent from their share of the total value of production. Subsidies may just be provided as non-product-specific support for agricultural producers in general.

3.3.2.2 Textiles and clothing

International trade in textiles and clothing, which amounted to about US$ 180 billion at the end of the last decade, was based to a large extent on the Multifiber Agreement (MFA) from 1974 (Islam 1990, p. 57). The MFA includes rules to regulate imports of textiles and clothing on a unilateral or bilateral basis using quotas and voluntary export restraints. Quotas exclusively restricted exports of developing countries that offered their products at low prices (Hauser/Schanz 1995, p. 156). Thus, basic principles of GATT regarding non-discrimination and renunciation of quotas have been offended

by the MFA. However, trade between industrialized countries was mainly characterized by tariffs. Against this background, it was an important request of the Uruguay-Round to integrate trade in textiles and clothing into GATT:

- The "Agreement on Textiles and Clothing" determines a transition period of 10 years until 2005 when trade has to be fully integrated into GATT. All countries have to replace quotas by tariffs in four steps: 16 % of the total volume of 1990 imports of textile and clothing products in 1995, another 17 % must be integrated until 1998, another 18 % until 2002 and the remaining 49 % at the end of the transition period. Thus, transformation of quotas into tariffs is asymmetric. Until the end of 2004, just 51 % of the import volume of 1990 is subject to WTO-rules.

- During the transition period, countries may introduce special safeguard measures that differ from Article XIX GATT. These measures can only be applied to products that are not yet integrated into GATT and when imports cause or threaten serious damage to the domestic industry. However, these measures may be applied selectively.

From an economic perspective, liberalization of world trade in textiles and clothing may result in a more efficient allocation of global resources. The abolition of the Multifiber Agreement will strengthen the credibility of the multilateral trade system.

The analysis of quantitative import restrictions has shown that bilateral agreements can be useful as long as quotas against third countries are not

diminished. A free trade area including Mexico may lead to considerable trade creation:

- The EU and NAFTA, especially Mexico, have to reduce bilateral restrictions faster than has been ruled by the WTO.

- Safeguard mechanisms for competing companies in the textile and clothing sector should be deleted.

3.3.3 Recent controversial issues

3.3.3.1 GATS

In comparison to goods, market entry for services depends on more comprehensive conditions. Services regularly involve interaction with the respective client. It is not usually possible to concentrate "production" in a single physical site. Instead, the service firm has to provide its services wherever the client is located. Thus, site selection may be dictated by the client. For example, banks can only export many of their services when they establish branches in foreign markets and when employees are allowed to cross borders.

The service sector in developed economies is growing continuously. Its share of the gross domestic product of many countries amounts to 50 %. Furthermore, border crossing transactions in services continue to gain in importance; presently, they total to already more than 20 % of the world trade

volume. Under this background, the Uruguay-Round carried out negotiations on the liberalization of international trade in services for the first time. The main task was to fill the existing legal gap and to develop a multilateral regulatory framework for trade in services. The "General Agreement on Trade in Services" (GATS) is characterized by the following rules:

- Generally, the "most favoured nation"-principle prohibits foreign suppliers of services from discriminating against one another. However, there are exceptions for certain sectors that are reviewed after five years and have to terminate after ten years. For example, cable or broadcast distribution of radio or television programming and parts of the air transport sector are excluded, whereas basic telecommunications and maritime transport services are subject to further negotiations. Besides, rules for financial services include further specifications.

- Regional agreements on integration, as TAFTA, are permitted even if they contradict the principle of non-discrimination, provided that markets for services are substantially opened in general (Hauser/Schanz 1995, p. 198). Moreover, protection against third countries must not be increased.

- GATS includes a very comprehensive definition for trade in services. Although most services are covered by the agreement, they do not all benefit from the same treatment. Each member can determine to what extent it will accord market access to foreign service providers. National "scheduled services" are listed in a "Member's Schedule" that comprises details of market access for specified sectors as well as conditions and

limitations with respect to national treatment. A country cannot accord treatment less favourable than this. Since a country is allowed to modify or withdraw a commitment at any time after it has been in effect for at least three years, long-time planning for foreign service firms is subject to uncertainty. On the other hand, if proper compensation is not provided, retaliatory measures are likely to be authorized. Again, there are special regulations for commitments on financial services.

- Countries are obliged to ensure that monopolies do not exercise their privileges in a way that offends against the rules of GATS.

If markets for services are opened on a bilateral level, trade may be diverted. Thus, regulations by GATS for regional integration are helpful, since they aim at trade creation. Regarding TAFTA, there is the possibility for a more comprehensive liberalization than there has been for the Uruguay-Round, because of different interests between developing and industrialized countries:

- The process of opening markets should refer to all sectors, especially those that may face a relatively high pressure for adaptations. In Germany, sectors as telecommunication, where foreign companies should be able to participate in public tendering procedures, and air transport, where gate and lending rights should be covered by GATS, have to be further liberalized. Inefficient providers of services are forced to adapt to increasing competition or they will be replaced by more efficient companies.

- Further negotiations on "Member Schedules" are necessary once new services are developed. Thus, new services may automatically become "scheduled services". Besides, TAFTA-countries may agree to a different approach than chosen by GATS. Countries may introduce schedules that just include services that are excluded. As a result, service sectors that are not mentioned in a respective schedule are accessible to a pre-defined extent.

- The principle that a country is obliged to treat foreign companies no less favourably that its own once market access has been granted may be judged as insufficient if foreign regulations are less restrictive than domestic regulations. In this sense, foreign firms that export their services are in a poorer position abroad than in their respective home markets. As a result, TAFTA may increase the competition among national regulations.

- Once market access has been granted to a service sector, it should be more difficult to withdraw a commitment.

- All countries should commit themselves to open sectors that are currently monopolized.

3.3.3.2 TRIMs

Many countries influence the general conditions for foreign investments by providing incentives or making conditions. As far as such actions lead to distortions and restrictions, they are called "Trade-Related Investment Measures". From a company's perspective, such conditions increase production costs and diminish the profitability of foreign direct investments. The "Agreement on Trade-Related Investment Measures" (TRIMs) is the first multilateral agreement on foreign investment.

- The agreement applies to investment measures related to trade in goods only.

- Countries are obligated neither to apply any measure that is inconsistent with the national treatment principle nor to implement quantitative restrictions. These rules refer to Articles III and XI of GATT and are concreted in an annex that contains an illustrative list of measures. Developed countries have to eliminate all trims over a transition period of two years.

Regarding TAFTA, investment measures between the EU and NAFTA - as far as they exist - have to be comprehensively reduced. Furthermore, measures that effect services should be included in an agreement, too.

3.3.3.3 TRIPs

Negotiations on intellectual property rights during the Uruguay-Round were difficult because of controversial points of view between industrialized and developing countries. While the former demanded to increase the protection, the latter were frightened of falling further behind in terms of competitiveness. If intellectual property rights for new products and noted trademarks are not protected, producers will be threatened by drops in turnover on domestic as well as foreign markets because of imitations, especially in such sectors as information technology, electrical engineering and pharmaceuticals (Hauser/Schanz 1995, p. 211 f.). During the Uruguay-Round, member countries came up with the "Agreement on Trade-Related Aspects of Intellectual Property Rights" (TRIPs):

- Countries oblige themselves to protect intellectual property (e.g. patents, trademarks, service marks, industrial designs and trade secrets) for a certain amount of time by applying basic principles such as national treatment and most-favoured-nation treatment.

- Countries have to make available all necessary enforcement procedures including remedies to prevent infringement.

During the Uruguay-Round, industrialized countries were able to get their main issues accepted. For negotiations on TAFTA, countries may agree on shorter transitional periods.

3.4 Settlement of disputes

Agreements on TAFTA will be subject to interpretation. NAFTA and the EU will possibly judge specific facts differently because of varying interests. Besides, affected companies must have the possibility to utilize the various laws provided by TAFTA. Past experience with international trade has shown that disputes are likely to occur and, thus, have to be settled. A central question is where a dispute settlement body should be implemented. There are several reasons why such a body should not be established as an independent institution of TAFTA:

- Bilateral dispute settlement does not only refer to companies of TAFTA-countries but also to firms of third countries. If those countries are excluded from dispute resolution procedures, their distrust against the new free trade area will rise caused by the fear that dispute settlements may discriminate non-participating nations and result in trade diversion.

- With an increasing number of free trade areas, the number of dispute settlement procedures will grow too, if every agreement includes its own dispute settlement system. Thus, companies that are involved in international trade face increasing confusion and uncertainty.

- Negotiations on TAFTA will be more difficult if participating countries have different opinions about procedures, composition of committees, or sanctions. For example, during the Uruguay-Round, the US suggested that

the dispute settlement body of the WTO should make its decisions by "consensus minus two", thus, by excluding the disputing parties (Hauser/Schanz 1995, p. 244).

- From an economic perspective, the implementation of a new institution to settle disputes causes high costs and binds scarce resources for dispute settlement.

As a result, TAFTA should renounce an independent bilateral dispute settlement body and use the WTO-dispute resolution system. Thus, distrust of third countries decreases, negotiations on TAFTA are less complex, and the WTO is backed up. Finally, the regulations of TAFTA are consistent with the WTO. The dispute settlement procedure of the WTO is "more legalistic and adjudicative in nature" than the former GATT-rules (Reif 1995, p. 141). The main problems had been that the composition of panels, the adoption of the panel reports and the authorization of retaliation measures had to be decided by consensus, including the disputing partners that had been able to block the procedure. The agreement of the WTO called the "Understanding on Rules and Procedures Governing the Settlement of Disputes" has taken some former criticism into consideration:

- The layered GATT dispute resolution system has been replaced by one body, the Dispute Settlement Body (DSB). The time period for the settlement procedure has been tightened, so that temporary gains resulting from breach of contract have been reduced correspondingly. Furthermore, the principle for consensus has been reversed; the establishment of panels,

the adoption of panel reports, and the authorization of retaliatory measures can only be rejected by consensus. This "automated" approval is limited in its stringency for the accused party by the implementation of an appellate body.

- If bilateral consultations of disputing parties fail to settle the dispute within 60 days, the complaining party may request the establishment of a panel. The DSB has to follow this request unless it decides by consensus not to establish a panel.

- Generally, panels are composed of three experts that must not be citizens of countries whose governments are disputing parties. The time period for the conduct of the panel process should not exceed six months. Besides, panels should consult regularly with the disputing parties. Panel reports are adopted unless a party decides to appeal or the DSB rejects the report by consensus.

- The standing Appellate Body is composed of seven experts. Three members work on a particular case. The appellate procedure shall conclude within 60 days. The final report is adopted unless it is rejected by consensus by the DSB.

- If a country fails to comply with the recommendations of the DSB, countries concerned are allowed to negotiate on mutually acceptable compensation. If no agreement is reached, the complaining party may

request authorization from the DSB for retaliatory measures. Suspensions should take place in the particular sector where the violation has occurred.

- In summary, every violation of a covered agreement of the WTO is subject to multilateral dispute settlement. Retaliatory measures have to be authorized by the DSB. Unilateral actions as those based on "Section 301" of the US-trade law can be taken to the DSB (Hauser/Schanz 1995, p. 245 f.).

The EU and NAFTA should further improve multilateral dispute settlement:

- Surveillance by the DSB of the implementation of its recommendations is crucial for the credibility of multilateral dispute settlement. Practical experience with the WTO-rules on dispute resolution will have to show if small countries can be effectively protected against violations of trade agreements by large countries. On the other hand, it is important that all retaliatory measures authorized by the DSB are monitored in order to avoid disproportionate new trade barriers.

- The EU and NAFTA should commit themselves to entirely renounce unilateral retaliatory actions.

3.5 Rules for negotiation

The analysis of chances and risks of TAFTA has shown so far that negotiations on a free trade area will be quite difficult. Thus, participating countries should agree to common rules for negotiation that could be followed as a guide. The starting point from where such rules can be derived is characterized by three distinguishing marks (Krugman 1991, p. 15 f.):

- Negotiations on trade agreements are based on mercantile thinking. The opening of domestic markets is judged as negative because imports threaten jobs in respective domestic sectors. Thus, liberalization of the domestic market is designated as a concession. On the other hand, the opening of foreign markets is assessed as positive, since the possibility of exports may enable the domestic industry to grow and to create or secure jobs.

- Generally, agreements are reciprocal. The EU will only open its markets if NAFTA countries liberalize too, and vice versa.

- An agreement on trade liberalization will only be reached if both sides win. If one party expects not to win, because costs caused by liberalizing the domestic market are higher than earnings from liberalized markets abroad, it will not consent to the agreement. Thus, both sides have to expect positive net profits, especially in a situation where the negotiating trading blocs are both so strong that no party can force its interests upon

the other nations. However, from an economic perspective, even a unilateral opening of the domestic market improves the situation of the liberalizing country because of dynamic gains based on increasing competition and improvements for consumers.

Against this background, a step-by-step procedure for negotiations on TAFTA can be derived. Both sides should agree to similar common rules before entering negotiations.

First, for industry sectors, where the EU as well as NAFTA expect to win if both sides liberalize to the same extent, it is less difficult to reach an agreement. This may be the case in sectors that are similarly protected and characterized by intra-industrial trade. Both sides will gain from mutual market liberalization resulting in trade creation. Examples may be the chemical or the automobile industry.

Second, an isolated settlement may not be possible for sectors where the EU or NAFTA expect to lose. This is likely to occur in sectors that are characterized by inter-industrial trade based on major differences in costs. On the other hand, different levels of protection affect the competitiveness of sectors. If both domestic and foreign markets are liberalized, the cheaper production will threaten the more expensive one. Hence, the party with the more expensive production will not agree to an isolated liberalization in this sector. Perhaps the European, especially the German, mechanical engineering industry will be able to improve to the debit of its competitors in North America. As a result, the governments of NAFTA-countries will probably disagree with liberalization. On the other hand, maybe the European electronics industry and agriculture will be endangered by increasing competition. Thus, such sectors have to be liberalized together as a "package",

so that both sides can combine expected disadvantages with even larger advantages.

Third, if it is not possible to agree on such a "package", parties concerned may consent to a liberalization that is automated and regulated. In all sectors where no agreement has been reached, existing non-tariff trade barriers, such as quotas and subsidies, should be replaced by equivalent tariffs. These duties should then be reduced linearly. In accordance with Article XXIV GATT, tariffs may be lowered by an annual rate of 10 %. Thus, within 10 years a comprehensive Transatlantic free trade area will develop. The wide time frame allows countries to adapt to increasing competition. Besides, "substantially all the trade" between the EU and NAFTA is included in the agreement on free trade as it is ruled by GATT.

3.6 Position of third countries

From an economic perspective, the foundation of TAFTA has to press ahead with the liberalization of worldwide trade. Generally, the more countries are included in a free trade area, the larger will be the advantages for each nation. The possibility to accede to the free trade area can be based on specific conditions. Third countries should only be allowed to enter TAFTA, and thereby be connected with a free access to the European and North American markets, if they open their domestic markets too.

Following this procedure has several advantages:

- Regional integration must not be a "detour" but can become a "shortcut" for the process of worldwide liberalization. The number of accessible foreign markets as well as the possibility of trading profits increase.

- Third countries are not excluded from a large fortified Transatlantic trading bloc. Thus, trade is not diverted and the danger of markets that mutually seal other nations off is removed.

- Generally, regional integration discriminates against third countries and offends the basic WTO-principle of non-discrimination. But, at least theoretically, if a free trade area covers more than 50 % of world trade, discriminating trade will decrease with each nation that joins this agreement.

- If countries that are interested in joining the free trade area are forced to accept all agreements, they cannot just liberalize those sectors that are expected to gain from open markets.

Possible countries that may apply for joining TAFTA once it is founded are those that are currently connected to countries of the EU or NAFTA by bilateral preferential agreements, e.g. the US and Israel, Canada and Australia as well as New Zealand, the EU and EFTA-countries as well as countries in Eastern Europe. If those partner countries are not allowed to join TAFTA, their original preferential agreements may be devalued because of

trade diversion caused by TAFTA. As a result, those original agreements may have to be re-negotiated. In summary, partner countries should have the possibility to choose between joining TAFTA by acceding to all agreements or voluntarily renouncing their participation.

4. Conclusion

The rise of regional trading blocs poses a special challenge to the multilateral system. The principle of non-discrimination that lies at the heart of the multilateral system is potentially put at serious risk by regional trading blocs which, by definition, extend more favourable trading rules to members than to non-members. The principle of non-discrimination has important economic and political rationales. From an economic perspective, regional trading blocs always entail some degree of trade diversion as well as trade creation and thus carry the potential of distorting global trade and reducing global economic welfare. From a political perspective, the principle of non-discrimination is designed to discourage countries from favouring single other nations.

The idea of a Transatlantic Free Trade Area (TAFTA) reflects the willingness of the European Union (EU) and the North-American Free Trade Area (NAFTA) for further trade liberalization. The Transatlantic Free Trade Area promises some advantages for both parties, but it also includes significant risks. The main problem of a free trade area between these two important trading blocs is that it weakens the multilateral approach of trade liberalization. Yet, the Transatlantic partners do not have to resign the potential gains from the liberalization by TAFTA, if they are willing to share these gains with other countries. Both the EU and NAFTA should force transferring the agreements of the Uruguay-Round and liberalize the sectors that are not at all or not sufficiently covered by the World Trade Organization (WTO).

The WTO offers the possibility to all its members to deepen their relationships beyond the minimum disciplines established. Bilateral and plurilateral strategies for market integration based on the fundamental WTO principles could lead to a global network of nations. One central challenge is to avoid the perception that TAFTA is seeking to exclude third nations. The membership of such a free trade area should be open to any country prepared to accept the obligations to which existing members have committed.

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